

ST 02-12

Tax Type: Sales Tax

Issue: Gross Receipts

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**ABC Utility Co.,
Taxpayer**

**No. 00-ST-0000
IBT # 0000-0000
Claims for Credit
Tax pds.: 1/93—5/98**

**Charles E. McClellan
Administrative Law Judge**

RECOMMENDATION FOR DECISION

Appearances: Mark Dyckman, Special Assistant Attorney General, for the Department of Revenue; Lisa A. Husten and J. Robert Barr of Sidley, Austin, Brown & Wood, for the taxpayer.

Synopsis:

This matter involves Notices of Tentative Claim Denial issued by the Department of Revenue on July 26, 2000, for two groups of amended sales and use tax returns and related claims for credit or refund filed by ABC Utility Company (“ABC” or the “taxpayer”). The first group of claims, (the “the buyout claims”) filed on February 8, 1999, claim refunds in the aggregate amount of \$38,115,110. These claims are for self-assessed use tax paid for the period January 1994 through May 1998 with respect to

contractual buyout payments¹ ABC made to terminate certain contractual obligations to purchase coal for fuel in its electric generating plants.

A pre-trial order was entered on April 10, 2001. The issue raised by the buyout claims was phrased in the pre-trial order as follows:

Whether the entire amount or only part thereof, that was paid under the contract between ABC and XYZ is taxable as “gross receipts for the purchase of coal.

The second group of claims, (the “fly ash claims”), also filed on February 8, 1999, claim refunds totaling \$2,406,259. These claims are for credit of use tax self-assessed on coal purchased during the periods beginning January 1993 through May 1998. These claims are for tax paid on that part of coal purchased by ABC that becomes fly ash and slag, also called bottom ash, in the burning process. ABC sells the fly ash as an ingredient in cement and the slag for processing into roofing shingle granules. The issue raised by the second claim was phrased in the pre-trial order as follows:

Whether the portions of ABC’s coal purchases in the amounts claimed that result in the production of fly ash and slag that is sold to third parties qualifies as non-taxable purchase for resale.

An evidentiary hearing was held on July 26, 2001. A stipulation was filed at the commencement of the hearing in which the parties stipulated to facts and the authenticity of the documents identified as Exhibits 1 through 11. Testimony regarding only the buyout claims was given during the evidentiary hearing by Mr. John Doe (“Doe”), a 35-year employee of ABC. Doe was ABC’s manager of fuel from 1992 through 1998. Following the evidentiary hearing, both parties filed briefs.

My recommendation is that the Notices of Tentative Claims Denial be made final.

¹ These payments are sometimes referred to as *buyout payments* in the transcript and briefs filed by the

Findings of Fact:

1. During the years at issue, ABC was engaged in the business of producing and distributing electric energy to retail electric customers in Illinois. (Tr. p. 16)
2. During the period January 1993 through May 1998, ABC purchased coal from various mines. (Stip. ¶ 1)
3. ABC burned the coal at its facilities in Illinois to produce heat to turn water into steam that was then pressurized and used to turn turbines that turned generators to produce electricity. (Stip. ¶ 2)
4. There is no issue or controversy regarding the dollar amounts or the methodology used by ABC to calculate all of its refund claims at issue and if it is determined in this proceeding, or on appeal therefrom, that ABC is entitled to any refunds, the refunds shall be in the dollar amounts set forth in their refund claims. (Stip. ¶ 3)

Amended Contract Refund Claims

5. In May 1976, ABC entered into a long-term contract with XYZ Coal Company (“XYZ”) to purchase western coal from XYZ at a base price that increased from year to year. The contract was a “take or pay” contract which required ABC to pay for a specific tonnage of coal each year, regardless of whether ABC actually needed the coal or physically took possession of the coal. (Stip. ¶ 14; Stip. Ex. No. 8; Tr. p. 17)
6. The contract between ABC and XYZ obligated ABC to purchase coal through the calendar year 1999. (Stip Ex. No. 8)

parties. They will also be referred to as *buyout payments* in this recommendation.

7. In the early 1990's, the price range of western coal on the open market was approximately \$3.00 to \$5.00 per ton of coal. During this same period, ABC was paying XYZ, pursuant to the 1976 contract, in excess of \$30.00 per ton of coal. (Stip. ¶ 15, Tr. pp. 22-23)
8. In 1993, ABC entered into the Amended and Restated 1976 Coal Purchase Contract with XYZ (Stip. ¶ 16; Stip Ex. No. 10). Under this contract, ABC did not take any more coal from the XYZ mine. ABC found alternative coal mines and negotiated new contracts with the alternative mines for ABC's coal needs. In some cases, the alternative source contracts were then assigned to XYZ by ABC. In other cases, ABC had XYZ sign the contract after ABC had negotiated all the terms. ABC took possession and control of the coal as it was loaded into the rail cars at the mines. The coal from the alternative mines was shipped directly to ABC. Stip. Exs. No. 11 and 12 are two examples of such alternative source contracts. (Stip. ¶ 16)
9. The invoices ABC received from XYZ identified the shipment date, the shipment number, the train number (which identifies the train and location from which the coal was shipped), the number of coal cars in the train, the type of coal and tonnage, the "Price" charged by the alternative source mines from which the coal was shipped, the BTU² of the coal, the ratio of actual BTU content to the BTU content required under the contract, and the BTU adjustment for coal that differs from the BTU contract rate, the "Price BF BTU" which was the contract price consisting of the alternate source

² The letters BTU are an abbreviation of the phrase *British thermal unit* which is the quantity of heat required to raise the temperature of one pound of water by one degree Fahrenheit. *Webster's New College Dictionary*, 1995 ed., p. 139. In the coal industry, it is a measure of the heat energy contained in a measure of coal. Tr. p. 24.

coal price before the BTU adjustment plus the current net billing price, the “Total Price” which was the alternative source coal price with the BTU adjustment plus the current net billing price, and the “Total Amount” which was the Total Price times the tonnage. Stip. Ex. No. 7 is a sample invoice. (Stip. ¶ 17)

10. The “current net billing price” is defined in the contract and in Amendment No. 3 to the amended contract to be the buyout amount. Tr. p. 66. It is shown as such on the invoices ABC received under the contract from XYZ in the column entitled “Price BF BTU” This price is made up of the price per ton for the alternate source coal and the buyout amount. (Tr. p. 59.)
11. When XYZ invoiced ABC for coal purchased from an alternate source mine, the invoice listed a charge for a portion of the buyout as well as for the coal. XYZ would keep the buyout payments and pass on the payment for the coal to the alternate source mining company that mined the coal. (Tr. pp.49, 53-55, 58-60; Stip. Ex. No. 10, § 6.01)
12. On February 8, 1999, ABC timely filed Illinois amended sales and use tax returns for the period January, 1994 through May, 1998, with an accompanying claim for credit in the amount of \$38,115,110 with respect to certain payments it had made under the Amended and Restated 1976 Contract with XYZ. (Stip. ¶ 18; Stip. Ex. No. 4)
13. On July 26, 2000, those claims were tentatively denied and ABC timely filed a protest on August 14, 2000. (Stip. ¶ 19; Stip. Exs. No. 5, 6)

Fly Ash and Slag Claims

14. When ABC burned the coal in its boilers, most of the coal was consumed in the form of heat energy. Two intentionally produced by-products from burning the coal, however, remained. They were fly ash and bottom ash or slag. (Stip. ¶ 4)
15. Fly ash is the residual ash that goes up the stack of the boiler and is collected by an electrostatic precipitator. (Stip. ¶ 5)
16. The fly ash produced from the coal used by ABC during the period in question was of a construction grade and was resold to be used as a major ingredient in cement. (Stip. ¶ 6)
17. During certain months of the year when cement could not be poured, the sold fly ash had to be stored before it could be delivered. (Stip. ¶ 7)
18. Slag, also known as bottom ash, is the heavier, left over ash that falls to the bottom of the boiler. (Stip. ¶ 8)
19. The slag produced from the coal used by ABC during the period in question was resold to be used primarily as roofing granules (a component of roofing shingles). (Stip. ¶ 9)
20. ABC regularly and consistently negotiated for the resale of fly ash and slag both before and during the period in question. During the period in question, ABC entered into contracts with unrelated third parties for the sale of the fly ash and slag. XXX Fly Ash purchased and resold the fly ash. During the period in question, XXX Fly Ash was purchased by XXX Corporation and changed its name to XXX Solutions. Minerals Division of MMM purchased and resold the slag. (Stip. ¶ 10)
21. Typically, one ton of coal produced between 4% to 5% of ash by-product. (Stip. ¶ 11)

22. On February 8, 1999, ABC timely filed Illinois amended sales and use tax returns for the period January, 1993 through May, 1998 with an accompanying claim for credit in the amount of \$2,406,259.00 with respect to its resale of fly ash and slag. (Stip. ¶ 12; Stip. Ex. No. 1)
23. On July 26, 2000, those claims were tentatively denied and ABC timely filed a protest on August 14, 2000. (Stip. ¶ 13; Stip. Exs. 2, 3)

Conclusions of Law:

Background

During the years at issue, ABC engaged in the business of producing and distributing electric energy to retail electric customers in Northern Illinois. (Tr. p. 16) This matter involves Notices of Tentative Claim Denial issued by the Department on July 26, 2000 for two groups of amended sales and use tax returns and related claims for refund or credit filed by ABC. (Stip. Exs. No. 2, 5) The first group of claims, (the amended contract refund or buyout claims) filed on February 8, 1999 claim refunds totaling \$38,115,110. These claims ask for credit or refund of self-assessed use tax paid for the period January 1994 through May 1998, with respect to buyout payments ABC made to terminate certain contractual obligations to purchase coal for fuel in its electric generating plants. (Stip Ex. No. 4) The second group of claims ask for credit or refund of tax paid under the Illinois Use Tax Act³ for the portion of coal that is converted into fly ash and slag in the burning process that produces steam to drive the turbines that generate electricity. (Stip. Ex. No. 1)

³ Unless otherwise noted, all statutory references are to 35 ILCS 105/1, *et seq.*, the Illinois Use Tax Act. (UTA).

Amended Contract Refund Claims

During the 1970's, ABC was under a great deal of environmental pressure to reduce the amount of sulfur oxides emitted by its generating plants from the burning of coal to generate electricity. (Tr. p. 21) One way to reduce the amount of sulfur emissions was to burn lower sulfur content western coal rather than high sulfur Illinois coal. *Id.* So, to reduce sulfur emissions, ABC entered into several contracts to purchase western coal that contained less sulfur and would emit fewer sulfur oxides in the burning process. (Tr. p. 17) One of these contracts was with XYZ Coal Company ("XYZ") which was signed in 1976. (*Id.*, Stip. Ex. 8) The contract bound the parties through 1999, and specified a base price of \$13.75 per ton that was adjusted pursuant to an escalation clause based on an index formula specified in the contract. (Tr. pp. 21-22, Stip. Ex. 8) The contract was a take or pay contract which required ABC to pay for a specified amount of coal each year whether or not it took delivery of the coal. (Stip. ¶ 18-19)

ABC also had agreements in 1982, 1983, 1986 and 1988 with XYZ called "reserve coal arrangements". (Tr. p. 19) Under these agreements, ABC would pay for about two-thirds of the contract price of coal at the time the coal was to have been produced, but the coal would be kept in the ground. That coal would be mined much later for the remainder of the contract. (*Id.*) Three types of documents were executed to consummate the reserve coal arrangements. The first document was an amendment to remove from the coal contract the quantity of coal that was to be reserve coal. The second document was a lease-purchase agreement that contained the terms and conditions for buying the coal in the ground and creating a leasehold interest in that coal for ABC.

The third document was a mining agreement that contained the terms and conditions for the mining of the coal at a later time. (Tr. p. 20)

Over time, the price of coal under the coal contract escalation clause rose so that by the early 1990's the price was in excess of \$30.00 per ton for coal under the XYZ contract, although the price of coal on the open market was between \$3.00 to \$5.00 per ton. (Tr. pp. 22-23) The open market price was so much less than the XYZ contract price because by the 1990's additional mines had been opened mining western low sulfur coal. (Tr. p. 24)

The Illinois Commerce Commission ("Commission") reviewed ABC's coal contracts as part of its annual prudence reviews that were part of its fuel clause reconciliation dockets. The Commission found that ABC's contracts had been prudently entered into for 1982 through 1985. (Tr. pp. 24-26) However, in the early 1990's the Commission conducted a comprehensive management audit of ABC and found that the coal contracts were above market price and that ABC should be able to do something to reduce the cost of western coal. (*Id.*)

As a result of the Commission's findings, ABC asked XYZ how much it would cost to buy out the XYZ contract on a lump sum basis. The response was \$900,000 which was beyond ABC's means at that time. (Tr. p. 26) XYZ proposed that ABC buy out the contract over a nine-year period. ABC calculated the present value of the extended buy out to be \$690,000. (Tr. p. 27) This buyout amount was made up of three elements: 1) \$502 million that XYZ would lose because ABC would no longer be purchasing any XYZ coal; 2) \$178 million in profits XYZ would lose because of coal XYZ would have purchased from another company, YYY Coal Company, and sold to

ABC but that would now be purchased directly by ABC from the other company (Tr. pp. 28, 58); and 3) \$10 million that XYZ would have made from an oiling contract.⁴ (Tr. pp. 28,58) Since ABC would no longer be taking coal from the XYZ mine, the oiling service would no longer be necessary. (Tr. p. 31) These provisions resulted in a savings for ABC of \$210 million over the original \$900 million lump sum proposal realized over the nine year period.

XYZ also benefited from the buyout arrangement. It wanted these more favorable terms for a number of reasons. XYZ had negotiated an arrangement with the Internal Revenue Service to defer over the nine-year buyout period the income from the coal ABC purchased under the reserved coal arrangements. Under this arrangement, even though ABC paid for two-thirds of the coal each year, and the balance later when the coal was actually mined, XYZ could defer recognizing that income for federal income tax purposes until the coal was actually mined or the contract was terminated. (Tr. pp. 29-30) If the parties had negotiated a lump sum buyout and terminated the contract, XYZ would have had to recognize the lump sum as income for federal income tax purposes in one year. (*Id.*)

There were other benefits to XYZ by negotiating a nine-year buyout. It retained the profits it would have earned if the contract had continued without amendment until the end of its term. (Tr. pp. 28-29) XYZ avoided having to invest in additional mining equipment. (Tr. p. 29) Also, XYZ did not have to open the additional pit that would have been necessary to provide the coal purchased under the original contract. (*Id.*) For

⁴ The oiling contract was a contract between XYZ and ABC under the terms of which XYZ would spray oil on the coal at the XYZ Mine. (Tr. p. 31)

these reasons ABC and XYZ agreed to amend the 1976 contract which they did effective January 1, 1993. (Tr. pp. 33-34; Stip. Ex. No. 10)

Under the amended contract, a back up provision provided that if it was physically impossible to obtain western coal from other sources, XYZ could supply coal to ABC. (Tr. p. 45) Otherwise, under the amended contract XYZ was not permitted to supply coal to ABC from the XYZ mine. XYZ was required to deliver all coal after 1992 from the XXX Mine and the XXXX Mine, both in Wyoming. (Stip. ¶ 16; Stip. Ex. No 10, p. 2, § 1.01) From that point on ABC solicited bids and negotiated all terms, including price, with new coal sources. (Tr. pp. 38-41) XYZ had no input or involvement with respect to the purchase of the alternate coal sources. (*Id.*)

When ABC negotiated the contract terms and prices for the new coal, it assigned the contract to XYZ, or, if ABC wrote the contract in XYZ's name as the buyer, ABC had XYZ execute the contract for ABC. (Tr. p. 41) After ABC assigned the alternate source coal contracts to XYZ, XYZ could not exercise options or make decisions about the alternate source coal because that authority was reserved to ABC. (Tr. pp. 41-44. Stip. Ex. No. 10, p. 3, § 1.01; p. 3A, § 1.02) Under the alternate source coal contracts ABC retained the sole the authority to amend the contracts, and to resolve disputes arising under the contracts. (*Id.*) ABC was solely responsible under these contracts to perform all of the buyer's duties. (*Id.*) ABC was entitled to any compensation payable to the purchaser in the event that the coal was not loaded timely in the railroad cars. (*Id.*)

Under the provisions of the amended contract, XYZ elected to have ABC take all remaining tonnage from the alternate source mines. (*Id.*) As a backup measure, the

amended contract provided that if it was physically impossible to obtain any coal from any alternate source mine, ABC could obtain coal from the XYZ mine. (Tr. pp. 45-46.)

To deliver the coal from the mines from the alternate source mines to ABC generating plants, ABC negotiated new contracts with the railroads. (Tr. p. 46) The new rates were more favorable to ABC than the old rates because the alternate source mines were in an area of Wyoming that was served by two railroads, so there was competition between the railroads for the business. (*Id.*) ABC was able to buy its way out of the old railroad contracts over time and to pass the buyout costs through the fuel clause. (Tr. pp. 47-48) ABC saved about \$700 million as a result of the renegotiation of its contracts with the railroads. (*Id.*) ABC's renegotiation with XYZ resulted in savings of about \$1.1 billion, for a total savings on the renegotiation of \$1.8 billion, all of which it passed on to its customers. (*Id.*)

At the time the amended contract went into effect, the market price of western coal ranged from \$3.00 to \$5.00 per ton. (Tr. pp. 4, 40; Stip. ¶ 15) The price ABC paid for coal from the alternate source mines during the period 1993 through 1998 was \$3.00 to \$5.00 per ton. (Tr. p. 50) ABC took title to the coal mined from the alternate source mines at the mine and it was shipped in ABC owned rail cars to its generating plants. (Tr. pp. 48-50; Stip. Ex. No. 10, § 3.01; Stip. Ex. No. 12, § 5.02) The price per ton was reflected on the invoices prepared by XYZ. (*Id.* Stip. ¶ 17, Tr. p. 59-61; Ex. 7, 10, § 6.01)

When XYZ invoiced ABC for coal purchased from an alternate source mine, the invoice listed a charge for a portion of the buyout as well as for the coal. XYZ would

keep the buyout payments and pass on the payment for the coal to the alternate source mining company that mined the coal. (Tr. pp.49, 53-55, 58-60; Stip. Ex. No. 10, § 6.01)

ABC sold its fossil fuel burning generating plants in 1999 and ceased purchasing coal from any source. At that time, the amended XYZ contract was amended again to require ABC to continue paying the buyout, identified as the “net billing price” on the invoices, on the same schedule as before although no coal was being purchased or delivered. (Tr. pp. 67-71; Stip Ex. No. 10, Amendment No. 3) Thus, ABC continued to pay the net billing price although ABC was no longer operating coal burning plants and was no longer purchasing coal. Tr. pp. 70-71)

ABC maintains that during the years at issue, it erroneously self-assessed use tax on the buyout payments which were included in the total invoice amounts for the coal purchased. ABC asserts that the tax should not have been self assessed on that portion of the invoice price that represented the buyout payment because the buyout payment was not part of the cost of the coal it purchased.

The Department’s *prima facie* case is established by the admission into evidence of the records of the Department under the certification of the Director at a hearing before the Department or any legal proceeding. 35 ILCS 120/8⁵ Central Furniture Mart v. Johnson, 157 Ill.App. 3d 907 (1st Dist. 1987); Copilevitz v. Department of Revenue, 41 Ill.2d 154, 242 N.E.2d 205 (1968) Therefore, the Department’s *prima facie* case was established when the notices of claim denial were introduced into the record by inclusion in the stipulation under the certificate of the director.

⁵ The Use Tax Act makes numerous sections of the Retailers’ Occupation Tax Act (35 ILCS 120/1 *et seq.*) applicable to the Use Tax including 35 ILCS 120/8. 35 ILCS 105/12.

When a taxpayer claims that it is exempt from a particular tax, or where it seeks to take advantage of deductions or credits allowed by statute, it has the burden of proof. This derives from the fact that deductions and exemptions are privileges created by statute as a matter of legislative grace. Statutes granting such privileges are to be strictly construed in favor of taxation. Balla v. Dept. of Revenue, 96 Ill. App. 3d 293, 295 (1st Dist. 1981).

To overcome the Department's *prima facie* case, the taxpayer must present consistent, probable evidence identified with his books and records. Copilevitz v. Department of Revenue, 41 Ill.2d 154, 242 N.E.2d 205 (1968); Central Furniture Mart v. Johnson, *supra*. Testimony alone is not enough. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill.App.3d 203, (1st Dist. 1991); A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833-34 (1st Dist. 1988)

Taxpayer' has failed to overcome the Department's *prima facie* case. The tax at issue in this matter is the use tax imposed by the Use Tax Act ("UTA"). The use tax is a tax upon the privilege of using personal property within Illinois. 35 ILCS 105/3 *et seq.* United Air Lines, Inc. v. Johnson, 84 Ill. 2d 446, 419 N.E. 2d 899 (1981). Section 105/3 of the UTA provides that a "tax is imposed upon the privilege of using in this State tangible personal property purchased at retail from a retailer. . . ." (35 ILCS 105/3) The amount of use tax imposed on a purchase is determined by multiplying the "selling price" of the tangible personal property by the prescribed rate. 35 ILCS 105/3-10. The term "selling price" is defined in the UTA, in relevant part, as follows:

"Selling price" means the consideration for a sale valued in money whether received in money or otherwise, including cash, credits, property other than as hereinafter provided, and services, . . . and shall be determined without any

deduction on account of the cost of the property sold, the cost of materials used, labor or service cost or **any other expense whatsoever**, . . . [Emphasis added].
35 ILCS 105/2.

The Department's regulation, in relevant part, provides as follows:

In computing Retailers' Occupation Tax liability, no deductions shall be made by a taxpayer from gross receipts or selling prices on account of the cost of property sold, the cost of materials used, labor or service costs, idle time charges, incoming freight or transportation costs, overhead costs, processing charges, clerk hire or salesmen's commissions, interest paid by the seller, **or any other expenses whatsoever**. Costs of doing business are an element of the retailer's gross receipts subject to tax even if separately stated on the bill to the customer. [Emphasis added].
86 Admin Code ch. I, § 130.410.

The original contract between ABC and XYZ, signed in 1976, and the amended contract between ABC and XYZ, signed in 1993, were two versions of the same contract by which ABC contracted to purchase coal to be burned in its power plants to generate electricity. The provision in the original contract that stipulated the price of the coal provides as follows:

The base price of coal per ton (2,000 pounds) FOB cars, at the Mine, which complies with the standards set forth in Article IV hereof, shall be \$13.75. The base price shall be subject to the adjustments provided for in Article IV and IX hereof.
Stip. Ex. No. 8, § 8.01, p. 9.

Article IV provides for adjustments to the base price to reflect the quality of the coal that might be shipped from time to time. Article IX provides for adjustments to reflect changes in specified indices. *Id.* at § Article IX, p. 9.

When the price of coal under that contract escalated to over \$30 per ton, ABC negotiated the amended contract that provided for a buyout of the original contract. The basic contract provision in the amended contract that stipulated the price of the coal provides as follows:

The price per ton (2,000 pounds) of Base I Coal f.o.b. railroad cars at the Mine delivered from the Antelope Mine, or another Alternate Source Mine, is equal to the sum of (i) the total price, stated on a per ton basis, that Seller [XYZ] is obligated to pay pursuant to the applicable Alternate Source Contract, and (ii) the Current Net Billing price for the applicable period as determined.
Stip. Ex. No. 10, § 6.01, p. 14.

The “current net billing price” is defined in the contract and in Amendment No. 3 to the amended contract to be the buyout amount. Tr. p. 66. It is shown as such on the invoices ABC received under the contract from XYZ in the column entitled “Price BF BTU” This price is made up of the price per ton for the alternate source coal and the buyout amount. (Tr. p. 59.)

The pricing sections in the original contract and the amended contracts demonstrate that ABC agreed to pay a price per ton of coal as specified in the contracts. The buyout payment was not set out as a separate item. It was included in the contract price of coal purchased that was set forth in the contract. A basic tenet of contract law is that where an agreement between two parties is reduced to writing, and it is complete and unambiguous on its face, the writing affords the only evidence of the terms of the contract. Mertke v. Kracik, 122 Ill.App.2d 347, 259 N.E.2d 328 (1st Dist. 1969). The agreement between the parties must be determined from the writing itself. *Id.* In this case, the original contract and the amended contract provide for the purchase of coal and

nothing else. Therefore, the proper selling price for the coal was the billed price per ton without reduction for the buyout amount included therein.

Both the statute and the Department's regulation prohibit a reduction of the selling price for any expenses whatsoever. To reduce the selling price of the coal by the amount of buyout amount to determine the use tax base would violate both the statute and the regulation

In 1999, after ABC sold its fossil burning power plants it was still required to make the buyout payments, but those payments were for coal purchased under the contract. The fact that it was no longer purchasing coal because it had sold its fossil fuel burning power plants does not change the fact that it was a cost of the coal ABC agreed to purchase.

ABC argues that the use tax is imposed on the use of tangible personal property and that the real cost of the alternate source coal was the price the alternate coal source billed to XYZ for the alternate coal. It concludes that it should not be taxed on the buyout amount that XYZ included in the price that it billed to ABC for the alternate source coal. This argument ignores the fact that the contract for the purchase of coal was between ABC and XYZ. Even though ABC negotiated all of the terms of the alternate coal source contracts, and XYZ had no authority in that regard, the contract at issue is the contract between XYZ and ABC, not between the alternate source and ABC.

Taxpayer also argues that the fact that ABC and XYZ agreed to amend and restate the old contract to effectuate the buyout, rather than executing a new buyout contract is of no consequence. It argues that the substance of the contract controls and that under the

amended and restated contract, all of the prior rights and obligations of the parties were terminated.

This argument is incorrect. The statute clearly looks to title transfer and negates the application of the “substance over form” doctrine to transactions involving the ROTA and the UTA. In re Stoecker, 179 F. 2d 546, 550. (7th Cir. 1999), Weber-Stephen Products, Inc. v. Dept. of Revenue, 324 Ill.App.3d 893, 756 N.E.2d 321 (1st Dist. 2001) In this case the contract for the purchase of the alternate source coal was between XYZ and ABC. That contract identified ABC as the buyer and XYZ as the seller. The amended contract provided that title to the coal was f.o.b. the mine, and that title to the coal passed to the buyer at the mine. (Stip. Ex. No. 10, § 3.01, p. 4.) That agreement was between ABC and XYZ, and the price ABC paid XYZ for that coal included the buyout amount. As noted above, where an agreement between two parties is reduced to writing, and it is complete and unambiguous on its face, the writing affords the only evidence of the terms of the contract. The agreement between the parties must be determined from the writing itself. Mertke v. Kracik, *supra*. The price was not the price the alternate coal source billed to XYZ. The price was the price agreed to by XYZ and ABC in the contract.

Taxpayer argues that the Department’s regulation, 86 Admin Code ch. I, § 130.410, is not applicable to this case because the buyout was never made part of the price of the coal and was not being deducted from the price of the coal in violation of the regulation. This argument is incorrect because it would result in a reduction of the selling price by an expense, and that is prohibited by the statute and the Department’s regulation. The price clause in the amended contract clearly specifies that the price of the coal under

the amended contract is the sum of the price paid for the alternate source coal, the net current billing price as determined in the contract (the buyout amount) and the other adjustments provided for in the contract. Therefore, the price for the coal under the amended contract between ABC and XYZ includes the buyout amount. The net current billing price is simply another element that goes into the per ton price of coal such as the BTU adjustment and other adjustments specified in the contractual formula for determining the selling price.

The Production of Fly Ash and Slag

During the period January 1983 through May 1998, ABC purchased coal from various mines. (Stip. ¶ 1) ABC burned the coal at its facilities in Illinois to produce heat to turn water into steam which was pressurized and used to turn turbines which turned generators that produced electricity. (Stip. ¶ 2) When ABC burned the coal in its boilers, most of the coal was consumed in the form of heat energy. (Stip. ¶ 4)

The burning process also produced by-products consisting of fly ash and bottom ash or slag. *Id.* Typically, one ton of coal produced 4% to 5% of ash by-product. (Stip. ¶ 11) Fly ash is the residual ash that goes up the smokestack of the boiler and is collected by an electrostatic precipitator. (Stip. ¶ 5) The fly ash produced by ABC during the periods at issue was of construction grade and was resold to be used as a major ingredient in cement. (Stip. ¶ 6)

Slag, also called bottom ash, is the heavier, left over ash that falls to the bottom of the boiler. (Stip. ¶ 8) The slag produced from the coal used by ABC during the periods in question was resold primarily to be processed into the colored granules affixed to roofing shingles. (Stip. ¶ 9)

ABC regularly negotiated for the resale of fly ash and slag both before and during the period at issue. During these periods, ABC entered into contracts with unrelated third parties for the sale of the fly ash and slag. XXX Fly Ash purchased and resold the fly ash. Minerals Division of MMM purchased and resold the slag. (Stip. ¶ 10)

On February 8, 1999, ABC timely filed Illinois amended sales and use tax returns for the period January, 1993 through May, 1998 with an accompanying claim for credit in the amount of \$2,406,259 with respect to its resale of fly ash and slag. (Stip. ¶ 12) ABC alleges that it is entitled to a refund of the use tax it self-assessed on the portion of its coal purchases that was turned into fly ash and slag because ABC purchased it as an ingredient of property which it then resold. ABC relies on a portion of the statute that defines the phrase “sale at retail” and excludes from the definition property purchased for resale. That section of the statute provides, in part, as follows:

"Sale at retail" means any transfer of the ownership of or title to tangible personal property to a purchaser, for the purpose of use, and not for the purpose of resale in any form as tangible personal property to the extent not first subjected to a use for which it was purchased, for a valuable consideration: Provided that the property purchased is deemed to be purchased for the purpose of resale, despite first being used, to the extent to which it is resold as an ingredient of an intentionally produced product or by-product of manufacturing. For this purpose, slag produced as an incident to manufacturing pig iron or steel and sold is considered to be an intentionally produced by-product of manufacturing. 35 ILCS 105/2.

Statutory exemptions to taxation, such as the resale exemption sought by ABC in this case, are to be strictly construed in favor of taxation. Chicago Bar Ass'n v. Department of Revenue, 163 Ill.2d 290, 301; 644 N.E.2d 1166, 1171-72 (1994); Board of Certified Safety Professionals of Americas, Inc. v. Johnson, 112 Ill.2d 542, 547; 494

N.E.2d 485, 488 (1986); Richard's Tire Co. v. Zender, 295 Ill.App.3d 48 at 58, 692 N.E.2d 360 at 367 (2d Dist. 1998). The taxpayer seeking the exemption bears the burden of proving clearly and conclusively that it is entitled to them. See Chicago Bar Ass'n, 163 Ill.2d at 300, 644 N.E.2d at 1171; Board of Certified Safety Professionals of Americas, Inc. v. Johnson, 112 Ill.2d at 547, 494 N.E. 2d at 488; United Airlines v. Johnson, 84 Ill.2d 446, 455; 419 N.E.2d 899, 904 (1981). Further, all facts and debatable questions must be construed in favor of taxation. Wyndemere Retirement Community v. Department of Revenue, 274 Ill.App.3d 455, 459; 654 N.E. 2d 608, 611 (2nd Dist. 1995), XL Disposal Corporation, Inc. v. Department of Revenue, 304 Ill.App.3d 202, 709 N.E.2d 293 (4th Dist. 1999); App. Den. 185 Ill.2d 670, 720 N.E.2d 1107 (October 6, 1999)

ABC's application of the statute is incorrect. For a substance to qualify for the resale exemption as an ingredient of a product that will be sold by the taxpayer, the statute specifically requires that the material for which the exemption is sought by the taxpayer must be resold as an ingredient of an intentionally produced product of manufacturing or a by-product of manufacturing. The coal that is turned into fly ash and slag is not a product of manufacturing or a by-product of a manufacturing process.

To be engaged in the business of manufacturing, a taxpayer must be conducting a manufacturing process in its business. The term "manufacturing process" is defined for purposes of the manufacturing and assembling machinery and equipment exemption provided by the statute, 35 ILCS 105/3-5(18), as "the production of an article of tangible personal property" 35 ILCS 105/3-50(1). The Department's regulation describes the manufacturing process using similar language as follows:

The manufacturing process is the production of any article of tangible personal property, whether such article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by procedures commonly regarded as manufacturing, processing, fabricating or refining which changes some existing material or materials into a material with a different form, use or name. These changes must result from the process in question and be substantial and significant. 86 Admin Code ch. I, § 130.330 (b)(2)

Although these definitions are set forth in the statutory provisions and the regulation allowing an exemption for machinery and equipment used in manufacturing, there is no reason to believe that the legislature meant something else in using the term “manufacturing” in the resale exemption provision at issue. ABC is not in the business of manufacturing tangible personal property. During the periods at issue, ABC was engaged in the business of generating and selling electricity, a service. The fly ash and slag were by products of that activity.

Over sixty-eight years ago, the Illinois Supreme Court held that public utilities, including ABC, are engaged in service businesses and not subject to retailers’ occupation tax. Peoples Gas Light Co. v. Ames, 359 Ill. 152, 155 (1934) (A public utility, such as ABC is engaged in a service business.) In enacting the Retailers’ Occupation Tax (35 ILCS 120/1 *et seq.*) and the Public Utilities Act (35 ILCS 620/1 *et seq.*) the legislature acknowledged that public utilities, such as the taxpayer, are selling a service and, thus, are different from retailers selling tangible personal property. *Id.* at 158; Farrand Coal Co. v. Halpin, 10 Ill. 2d 507 (1957) (The sale of electricity generated by a public utility through the coal burning process is a service, not a sale of tangible personal property within the ordinary meaning of the statutory language.) ABC is not engaged in a manufacturing enterprise. It falls into the category of a provider of service. The fly ash

and slag are not produced in a manufacturing process. They are byproducts from the combustion of coal to produce steam to generate the electricity provided in that service.

ABC relies on Columbia Quarry Company v. Department of Revenue, 40 Ill.2d 47, 237 N.E.2d 525 (1968). The issue in that case was whether the portion of limestone sold by the taxpayer to a manufacturer of steel that was converted into slag in the steel manufacturing process was subject to the Retailers' Occupation Tax. In that case a portion of the limestone was consumed during the steel making process and about 56.3% of the limestone was turned into slag which the steel manufacturer sold to railroad companies for road ballast. The court held that the portion of the limestone that was turned into slag was purchased for resale. Columbia Quarry is distinguishable from this case by the fact that the purchaser of the limestone was a manufacturer of tangible personal property, pig iron and steel, and the slag was a by-product of that manufacturing process. In this case, during the years at issue ABC produced and sold electricity at retail, which is a service, and the fly ash and slag are by-products of producing that service. It was not a manufacturer of tangible personal property, so under the plain language of the statute and regulation, it was not qualified for the exemption.

Finally, ABC argues that the Department is violating the constitutional principles of equal protection and uniformity by allowing the resale exemption for by-products of manufacturers of tangible personal property and denying it to taxpayers in the business of generating electricity. ABC argues that there is no rational basis for distinguishing between slag that is produced as a by-product from burning limestone in the manufacture of steel and the fly ash and slag that is produced as a by-product from burning coal to generate electricity. In support of its argument, ABC relies generally on U.S. Const.,

Amendment XIV, § 1 (due process and equal protection clause) and Ill. Const. Art. IX, § 2 (uniformity clause). Specifically, ABC relies on the following language of the uniformity clause of the Illinois Constitution that provides:

In any law classifying the subjects or objects of non-property taxes or fees, the classes shall be reasonable and the subjects and objects within each class shall be taxed uniformly. Exemptions, deductions, credits, refunds and other allowances shall be reasonable. Ill. Const. 1970, Art. IX, § 2.

The classification of people into two classes, one of which is taxed, and one of which is not taxed, must be based on a real and substantial difference between the two classes, and that classification must have some reasonable relationship to the object of the legislation or to public policy. Searle Pharmaceuticals, Inc. v. Department of Revenue, 117 Ill.2d 454, 468; 512 N.E.2d 1240, 1246 (1987).

Limiting the availability of the resale exemption at issue in this case to taxpayers that manufacture tangible personal property but not to service providers is a rational classification. Sales of tangible personal property at retail are subject to the Retailers' Occupation Tax. Sales of service are not. The courts have distinguished between the taxation of public utilities, such as ABC, and commercial companies for many years. Unlike commercial ventures, public utilities are engaged in rendering service, not in selling tangible personal property. People's Gas Light & Coke Co. v. Ames, 359 Ill. at 156-157. (Corporations that engage in commercial enterprises selling tangible personal property are very different in character from corporations known as public utilities.)

Limiting the resale exemption at issue in this case has a reasonable relationship to the objective of the Retailers' Occupation Tax Act. Commonly, the tangible personal property produced by manufacturers ultimately will be sold at retail in transactions

taxable under the Retailers' Occupation Tax Act. Under Section 7 of that Act, all sales of tangible personal property are subject to tax until the contrary is established, and the burden of proof in that regard is on the person claiming exemption. 35 ILCS 120/7.

Persons who are retailers are required to register with the Department as retailers. They are required to collect, account for and pay over to the Department Retailers' Occupation Tax on sales of tangible personal property at retail. 35 ILCS 120/2. Service providers are not required to comply with these obligations. Therefore, granting the exemption to manufacturers of tangible personal property that will normally be sold at retail and have the burden of complying with the provisions of the Retailers' Occupation Tax Act, but denying it to services providers who are not so obligated, bears a reasonable relationship to the legislative policy. Therefore, the Department's interpretation of the statute does not violate the uniformity clause of the Illinois Constitution.

Finally, it is worth noting that as a result of the Columbia Quarry case, the statute was changed to insert the last sentence of the statutory definition of the phrase "sale at retail" which reads: "For this purpose, slag produced as an incident to manufacturing pig iron or steel and sold is considered to be an intentionally produced by-product of manufacturing." 35 ILCS 105/2. Taxpayer's interpretation of this sentence would read into this sentence the phrase "or as an incident to generating electricity" after the word "steel".

That construction of the statute is incorrect. Taxing statutes are to be strictly construed. Their language cannot be extended or enlarged by implication beyond its clear meaning. Van's Material Co. v. Dept. of Revenue, 131 Ill. 2d 196, 202, 545 N.E.2d 695, 698 (1989). If the legislature intended to extend the exemption to the generation of

electricity, it could have included it as a qualifying activity in the sentence of the statute quoted above. The legislature did not do that, however. ABC's construction of the statute would imply a broader resale exclusion than is provided in the statute. That would violate the rule of statutory construction that bars enlargement by implication. Van's Material Co. v. Dept. of Revenue, *supra*.

For all of the above reasons, I find that the taxpayer has failed to present sufficient evidence to overcome the Department's *prima facie* case. Therefore, I recommend that the Notices of Tentative Denial be made final.

ENTER: March 27, 2002

Administrative Law Judge